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CONTRACT ENFORCEMENT INSTITUTIONS: HISTORICAL PERSPECTIVE AND CURRENT STATUS IN RUSSIA

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Executive Summary

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The policy analysis of Russia's transformation to a market economy has ignored the nature, evolution, and economic implications of contract enforcement institutions. This paper looks theoretically and historically at contract enforcement in economic systems. We present the nature and examine the role of legal contract enforcement institutions as well as of private order" institutions that are based on reputation and the coercive power of organizations other than the state. The informational needs and the function of arbitration in each of these types of institutions are discussed. This examination enables the study of the historical development of contract enforcement institutions in the USSR and the implications of the recent political and economic events on the development and functioning of contract enforcement institutions in Russia. The analysis illuminates the economic deficiencies of the current Russian system of contract enforcement and the need for appropriate policy.

To a large extent, the economic discussion about transforming Russia to a market economy has focused on issues central to neoclassical economics and macro economics. Accordingly, issues such as privatization (the transfer and definition of property rights over existing assets), budgetary constraint, and monetary policy have dominated the discussion. Although the importance and contributions of that discussion is beyond doubt, it reflects the concerns of Western economists, who have for long been examining the ability to influence economic performance within market economies. These insights are more significant to situations in which markets already exist than to situations in which markets have yet to be created. In devising transition policies, Western economists have implicitly assumed the existence of a market economy and hence, by and large, they have ignored the policy implications of the need to create markets. This paper focuses on the need for such a policy. It recognizes that the extent of the market is limited by the ability to conduct anonymous exchange of property rights over time and space. An economy's enforcement institutions determine the limit for such exchange and hence the extent of the market. Traditional accounts by economists view the state as the only means for providing contract enforcement. Recent developments in economic theory, however, have demonstrated the importance of private order institutions in enforcement. Our paper offers a unified treatment of these two approaches and elaborates on their relationship.

To evaluate the required policy with respect to contract enforcement, one must better understand the current situation in Russia. Since contract enforcement institutions exhibit path

dependence, this is impossible without a study of the process through which contract enforcement institutions in Russia have evolved. The paper examines this evolution from its beginning when Russia was a part of the USSR to the present. In particular, it elaborates on the inter-dependencies between political events and economic regulations on the nature, development, and efficiency of the Russian contract-enforcement institutions. It also points to the inter-relations between the means through which contract enforcement is achieved in Russia, economic efficiency, and social features of broader concern (such as the use of violence).

This study has two main policy implications. First, much more research has to be conducted to achieve a better understanding of contract enforcement within Russia. Second, the current contract-enforcement institutions inhibit entry of small firms. As such firms are a potentially important engine of growth, this inability hinders Russia's economic development. To foster growth, there is an urgent need to devise and influence private order institutions and legal mechanisms that would enable small firms to credibly commit themselves to respect their contractual obligations, thereby enabling them to be active participants in, and an important source of a Russian market economy.

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1. Introduction

Recently a Russian plant manager signed a multi-million-dollar contract with a Western company to supply equipment for his plant. Several days later the company officials found out to their astonishment that an identical contract had been signed with their competitor. When asked how he could do such a thing, the Russian executive answered absolutely seriously: "These days we have a market economy and competition. So I let them compete: whoever supplies the best equipment will get paid."

This anecdote illustrates two points. First, some Russian managers still do not understand the workings of the market economy and completely misinterpret some of its concepts. Second, and more significant for this paper, is this manager's complete disregard of a signed and supposedly legally binding contract. Understanding the behavior of decision makers in the Russian economy, and hence the economy itself, requires that one examine the institutions that determine which contracts are considered binding and which are not.¹

This paper provides theoretical framework for the understanding of contract enforcement institutions and elaborates on the mechanisms developed throughout history to ensure enforcement. This elaboration serves as a background for the examination of contract enforcement and the related institutions in the USSR and contemporary Russia (with special emphasis on the latter). We call attention to the similarity in the historical development of contract enforcement and the developments in Russia, and to various factors that determine the degree of usage of various institutions, namely, the historical path of development, cost effectiveness, and control over the use of coercive power. Most importantly, we hope that

¹ While our paper explicitly relates to Russia, similar situation prevails in other former soviet union states.

although the scope of this paper precludes detail examination of each of the institutions we discuss, this paper will nevertheless draw attention to the importance of contract enforcement institutions in Russia's transition to market economy and that this awareness will provoke additional research.

2. Contract Enforcement Institutions in Historical Perspective

Theoretically, a "good" is characterized by its physical attributes as well as by its location in time and space. An exchange transaction, or a contract, is an agreement among individuals with specific identities on property rights to goods. Note that unlike the casual way of defining contracts as legally binding, there is nothing in the economic definition above that requires or implies legal enforceability of the contract. The study of contracts in economics is, to a large extent, the study of the various institutions used to ensure contract enforceability. By "institutions" (or "mechanism"), economists mean any constraint that restricts the transacting parties and is not a technologically determined feature of the exchange.

When a person has to decide whether to enter into a specific exchange transaction, he or she takes into account the physical attributes of goods to be exchanged, the distance in time and space between the *quid* and *quo*, and the identity of the other party. In the theoretical world of perfect markets where contract enforceability is assured, the identity of the parties and the distance in time and place between the *quid* and the *quo* do not impose

any restrictions on the decision whether to assume an exchange transaction. Hence any mutually beneficial exchange is feasible.²

In reality, however, the institutions that support the exchange by ensuring compliance determine the feasible set of mutually beneficial exchange transactions. In other words, the nature of the contract enforcement institution determines the set of exchange transactions an individual is ready to assume, and hence it determines the feasible gains from exchange in the economy. The institutions that support exchange determine how close the economy is to a "perfect market" economy, in which contract enforceability does not hinder trade and any mutually beneficial exchange can take place independently of the parties' identities and the distance in time and place between the *quid* and the *quo*. To illustrate the effect of contract enforcement institutions on the ability to exchange, consider, for example, an economy in which exchange is supported only by social ties within a small community. Any distance between the *quid* and the *quo* is feasible in exchange among members of that community, but any gains from transacting with members of other communities are foregone. Markets for goods exchanged between members of different communities cannot function.

Within a modern capitalist economy the visible hand of the state, the legal system, provides an institution for contract enforcement that contributes greatly to the operation of the invisible hand of the market. Yet the visible hand of the state can support market exchange only up to a limit. Incompleteness of contracts, asymmetric information, the boundaries of the state's judicial power, and litigation costs limit the state's ability to support exchange. Nevertheless, the extent of the market is not determined solely by the state's

² For ease of presentation, we ignore budget constraints.

ability to support exchange, since "private order" institutions support exchange as well. Like the legal system, private order institutions facilitate exchange by securing property rights. They secure these rights, however, without relying on the authority of the state.

Various studies have traced how private order institutions facilitate exchange without explicitly relying on the legal system in modern capitalist economies. For example, Williamson (1983, 1985) elaborated on the role of "hostages" in supporting exchange between a firm and its suppliers when the transaction is characterized by non-verifiability and assets specific to the relations. The firm will retain property rights over the assets used by its suppliers in the production process to curtail their ability to act opportunistically. Klein (1989) demonstrated the important role of credit bureaus in the US economy enabling credit transactions despite the existence of *a priori* asymmetric information. Bernstein (1992) examined how extralegal contractual relations supported by commercial sanctions enable low-cost exchange to flourish in the international diamond industry. Macaulay (1963) documented that American businessmen are reluctant to use the legal system to mitigate their disputes because of the high cost of legal proceedings.

The co-existence of private order institutions and a legal mechanism for contract enforcement is not surprising. After all, the legal systems of capitalist economies such as England and the US are outgrowths of the interactions between the state-enforced legal codes and private order institutions.³ At the same time, the nature of the private order institutions themselves is shaped by the nature of the state and its legal system.⁴ Hence both private

³ For Europe see Caenegem (1992). For the US, see Auerbach (1983).

⁴ See Greif (1992).

order and legal institutions for contract enforcement are products of a complex, path-dependent dynamic process through which the institutional structure of an economy evolves.⁵ Different economies are likely to develop different institutional infrastructures as a function of their histories.⁶

Yet there are common elements in various institutional infrastructures that are due to three factors. First, various institutional infrastructures are products of a common motivation, the desire of human beings to "barter and exchange." Second, they are aimed at mitigating the same problems. Finally, they are based on the same set of principles. In other words, institutional infrastructures are constructed by applying some combination of the same set of basic contract enforcement mechanisms. An examination of this set of basic mechanisms and how they transpired in various historical episodes is a useful preface to the study of the particularities of the evolution of the Russian contract enforcement institutional infrastructure.

For an economic agent to enter a contract, he should expect ex-ante that the best the other party can do ex post is to follow the contract agreed upon. For contract enforceability to be "effective," these expectations should be fulfilled. The better certain informational preconditions are achieved, the more likely the expectations are to be fulfilled (although various contract enforcement institutions differ in the information necessary for their operation). By and large, information should be available regarding possible future contingencies, the identity of the parties involved, the actions available to each of them, and the return to each

⁵ The theory of path dependence is presented by David (1988, 1992a).

⁶ At the same time, institutional infrastructures are among a society's "carriers of history." See David (1992b).

from taking a specific action at each possible contingency. An important role of institutions is to generate, collect, provide, and disseminate such information.

Although the appropriate information is necessary for contract enforceability, it is far from being sufficient. For enforceability, information not only must be generated but also must be used in a manner that makes it known, beforehand that each party's best option is to follow the contract. Throughout human history this has been achieved by institutions that link current and future transactions. To illustrate this general principle, consider a credit transaction. If it is commonly known that not paying a debt implies future inability to borrow, a potential borrower may be able *ex ante* to commit himself to pay his debt *ex post* and thus receive the loan. He will be able to commit himself if the present value of the foregone future borrowing is higher than the gain from not paying the current debt, since the best a borrower can do is to pay his debt. Linking a current credit transaction with future credit transactions enables exchange. Clearly, linking credit transactions is not the only linkage that can be used to ensure contract enforceability. For example, failing to pay the debt may imply being thrown in jail. Linking the credit transaction to the "exchange" between the borrower, the lender, and the state ensures debt repayment as well.

As the above examples illustrate, the study of contract enforcement institutions requires the analysis of not only how information is generated but also of how this information is used to link transactions. The mechanisms linking transactions can be categorized by the nature of the punishment and reward administered and by who administers this remuneration. To limit the scope of this essay we ignore mechanisms based on ethics

and social pressure and elaborate only on mechanisms in which the nature of the remuneration is either physical (that is, entailing the use of *coercive power*) or *pecuniary*.⁷

The use of coercive force to enforce contracts associates economic transactions with the relations between individuals and their "rulers," that is, those who can use coercion to alter payoffs. The "ruler" is either what we identify as the state or other individuals or groups with relatively high coercive ability, such as the warlords of the past or the infamous Mafia of the present. Historically, the distinction between the former and the latter was often vague. The state and its legal enforcement organizations may have evolved from the desire of individuals or groups with relatively high coercive ability to increase their income by providing contract enforceability. As a matter of fact, Olson (1992) has claimed that the modern state evolved from groups of roving bandits who settled down and provided legal enforcement to their subjects in exchange for taxes. These sedentary bandits developed an autocratic state that, in some cases, evolved to democracy. The incentive for all these changes was the incentive of the rulers to provide legal enforceability of contracts and thus increase their tax base.

That rulers established legal systems to advance contract enforceability and hence their revenue is reflected, for example, in the historical records of England. In the *carta mercatoria* of 1303, for example, Edward I, the king of England, assured all alien merchants "... that every contract entered into by [them] ... shall be firm and stable," that is, will be enforced by the English legal system. The alien merchants paid for this protection: "[T]he

⁷ Throughout history social norms and customs have served as mechanisms for the reduction of transaction costs, and in particular as contract enforcement mechanisms. Ben-Porath (1980) discussed the importance of the family and close social surroundings as transaction facilitator. Analysis of peer pressure and social norms as incentive devices in small groups can be found in Kandel and Lazear (1992) and Kandori (1992).

above-mentioned merchants, every one of them,... have ... granted us... by way of custom..." specific amounts to be paid in the English ports.⁸ Similarly, to encourage foreign merchants to provide local traders with credit despite the slow litigation procedure of the local borough courts, some English boroughs during the 13th century took an extraordinary step. They paid foreign creditors out of town funds and later took a double indemnity from the local debtor.⁹

When contract enforcement is supported by a legal system, the incentives of that system are important in determining economic efficiency. Since many modern legal systems are financed by the state and thus provide legal services subject to budget constraints, they will not necessarily minimize cost. Historically, legal systems were usually financed by their litigants and attempted to maximize their own "profit" by controlling the volume of trials and their operation cost subject to the constraints imposed by technology and state regulations. The economic implications of such attempts depended on the nature of the particular institution and the extent of competition for legal services. For example, in France before the Revolution, local courts were paid by the litigants and faced little or no competition. In sharp contrast, the English legal system of that period was characterized by a multiplicity of jurisdictions and a high level of legal competition. The result was economically devastating for France, because the high cost of litigation prevented economic development. Profitable

⁸ English Historical Documents. Vol. III, pp. 515-6.

⁹ Plucknett (1949), p. 137.

projects that were not undertaken in France because of high litigation cost were carried out in England.¹⁰

Legal systems with the incentive to minimize their costs and facilitate contract enforceability would announce in advance a set of rules or laws to be used in determining who was at fault and how compensation would be determined. Such rules enable the parties to better evaluate the costs and benefits of their exchange under various contingencies, including the case in which one party cannot follow its contractual obligations. In that way, the legal system creates expectations regarding the likely outcome of trials, thereby reducing the need for actually using the legal system.

Another method often used by legal systems to facilitate exchange is to create an auxiliary arbitration organization. Applying for the assistance of a coercive institution may be costly in time, fees, delays, expenses associated with familiarizing the court with the details of that economic transaction, the costs that may arise because a court is committed to certain procedures in evaluating evidence, and so on. Hence the parties may prefer to seek arbitration by impartial experts who can discreetly provide quick decisions at low cost. Legal systems motivated to advance economic efficiency are likely to find it efficient to make the decision of the arbitrators legally binding. Indeed, in many historical cases arbitration emerged to facilitate exchange. For example, Argenti (1958) who investigated the operation of the legal system in Chios from 1346 to 1566 noted that *"the high proportion of extant notarial deeds which record the appointment of arbitrators [in civil cases], to whom disputes were referred for legally binding settlements, proves that this method of 'settling out of*

¹⁰ For discussion, see Rosenthal (1991).

court' was generally preferred to going to law, perhaps because justice was slow and expensive, perhaps because it was unreliable" (ibid., p. 464).

A legal system, like any other contract enforcement system based on coercive power, cannot support all beneficial exchange transactions. As discussed above, the operation of such systems is restricted by the extent to which information is available and by the system's incentives. Indeed, by and large, institutions based on linking economic transactions over time and/or across economic agents are at least as important in ensuring contract enforceability as institutions based on coercive power.

To illustrate the operation of such institutions, consider an economy consisting of two individuals who can gain from cooperation in every period, but of whom at least one can gain from cheating if the other cooperates.¹¹ Cooperation can be sustained if future cooperation is made conditional on past conduct and the present value of future gains from cooperation is higher than the one-period gain from cheating. Because this mechanism enables contract enforcement by the fear of losing future gains, it is also referred to as the "reputation mechanism." In variant of this mechanism, past behavior is used by economic agents to form beliefs regarding unobserved characteristics of other agents.¹² In particular, observing "honest" past behavior that is not induced by coercive power may foster "trust" among the agents in the sense that it strengthen belief in future honest behavior. Hence it enables, over time, a higher level of cooperation. Furthermore, as demonstrated by Boot et

¹¹ The discussion implicitly assumes an infinite horizon. It holds, however, also for cases when the horizon is finite but there is uncertainty when termination will occur or when there are multiple Pareto ranking equilibria in the stage game. For discussion, see Pearce (1992).

¹² The operation of reputation mechanisms was originally studied by Kreps et al. (1982).

al. (1993), economic agents may choose to contract outside the realm of law, even in transactions that can be supported by the legal system in order to acquire reputation and hence facilitate cooperation in transactions that cannot be supported by the legal system.

The ability of reputation to support exchange depends on the details of the situation. In particular, it will fail to support cooperation if the economic agents are not patient "enough" and hence do not value the future much, if the agents are risk averse and there is high uncertainty with respect to future payoffs, if agents have "outside options" that are "too" attractive relative to the future gains from cooperation, and if there is high probability that for exogenous reasons the parties will have to cease cooperating although none has cheated. To mitigate these types of problems, the basic mechanism above can be supplemented by the threat of retaliation from individuals who were not cheated in the past (that is, a "third party" enforcement). The credibility of the threat depends on the availability of information and the incentives for economic agents to participate in collective punishment. To illustrate the variety of institutional forms that can provide this information and incentives. Several historical examples are discussed below.

During the 12th and 13th centuries, the Champagne Fairs were the main center for international trade in Northern Europe. Milgrom et al. (1990) have argued that impersonal *contract enforceability among traders from various countries* at the Champagne Fairs was achieved by a Law Merchant system based on a multilateral reputation mechanism. This system enabled merchants to trade although there was no court that could force a merchant to meet his contractual obligations once he left the fair and each merchant was not expected to interact with any specific merchant frequently enough for a bilateral reputation mechanism to

ensure contract enforceability. To understand the operation of the Law Merchant system, suppose that each pair of traders is matched only once and each trader knows only his own experience. Since the fairs' court lacked the ability to enforce judgment once a trader left the fairs, assume that the court is capable only of verifying past actions and keeping records of traders who cheated in the past. Acquiring information and appealing to the court is costly for each merchant. Despite these costs, an equilibrium exists in which cheating does not occur, and merchants are induced to provide information to the court and acquire information from it. It is the court's ability to activate a multilateral reputation mechanism by controlling information that enables exchange and the provision and acquisition of information. By transmitting information only to merchants who never cheated and who provided information to, and acquired information from the Law Merchant system, it motivated merchants to take these costly actions and to be honest. If a trader cheated, he was unable to trade again. Hence a local court ensured contract enforcement through time although it could not use coercive power against cheaters.

Greif (1992) has examined how exchange was supported in the eleventh century Mediterranean trade between merchants and their overseas agents who handled the merchants' goods abroad. Because of the "international" nature of these agency relations, they could not be supported by the legal system. Furthermore, any individual merchant was unable to commit himself to future agency relations with any specific agent. Yet, at least among the group of traders examined, that of the Maghribi traders, agents were honest because the traders arranged agency relations through a peer organization that may be referred to as a coalition. Members of the Maghribi traders' coalition provided each other

with agency services, thus increasing the value of a member's capital. Each trader benefitted from being a coalition member more than he could have by establishing agency relations based on a reputation mechanism outside the coalition. Obtaining the benefits of coalition membership depended upon proper conduct in the past, and the short-run gain from cheating today was less than the long-run benefit an honest coalition member could obtain. Since this situation was common knowledge, the merchants perceived that the agents could not do better by cheating. In short, the traders used a *perpetuum mobile* -- the contractual relations among them reduced the transaction cost associated with agency relations and thus motivated each coalition member to honor his contracts.¹³

Once a group of individuals have generated enough rent due to their ability to support contractual relations, they can, under certain conditions, use this rent to assure contract enforcement between themselves and with others as well. To illustrate this point, suppose that in each period a member of a coalition would be matched with a non-member with whom he could beneficially cooperate had he been able to commit himself to respect the contractual relations between them. Yet, because the relations between these two particular people are not expected to repeat, simple reputation mechanisms can not support cooperation. Cooperation can be supported, however, if members of the coalition threaten to punish any member who would cheat an outsider. The group would be motivated to do so because otherwise none of them could benefit from cooperation. Recognizing that, the outsiders would be willing to cooperate with an insider.

¹³ For the operation of coalition in Mexican California during the 19th century, see Clay (1993).

The operation of multilateral reputation mechanisms such as those described above requires that the same action will be considered by various participants as cheating. For example, the operation of a coalition such as that of the Maghribi traders, is based on uncoordinated responses of merchants at different trade centers. For the threat of collective punishment to be credible, "cheating" must be defined in a manner that ensures collective response. If some merchants consider specific actions to constitute "cheating" but others hold a different opinion, the effectiveness of the collective threat is undermined. Various institutions based on collective punishments coordinate interpretations of actions differently. In the Maghribi traders' coalition, coordination was achieved by a set of cultural rules of behavior accepted by all the merchants. In the Champagne Fairs, coordination was achieved by the *ex post* decree of the local court. In other cases, coordination was achieved by arbitrators who, after examining the evidence, declared whether a specific action constituted cheating or not.

The discussion so far has treated institutions based on coercive power and institutions based on reputation as substitutes. The relations between these two types of institutions, however, are more complex. In some situations contract enforcement may be achieved only when an institution based on a reputation mechanism is supplemented by an organization with coercive power. Furthermore, the operation of the reputation mechanism can constrain the ability of an organization with coercive power to abuse its power and to renege on its contractual obligations.

To illustrate these two points, consider institutions that governed the relations between rulers and alien merchants in pre-modern trade. During this period, a ruler had a monopoly

over coercive power in his territory. Hence, in the absence of an institution that enabled a ruler to commit *ex ante* to secure the property rights of alien merchants, these merchants were not likely to frequent that ruler's territory, thereby depriving its population, the ruler, and the merchants of the benefits of trade.¹⁴ In particular, when there are many merchants who, as far as the ruler is concerned, are perfect substitutes for each other, a simple bilateral reputation mechanism fails to constrain the ruler from using his coercive power to abuse merchants' rights at the *efficient* level of trade. At that level, the benefit to the ruler from the future trade of the marginal trader (due to customs payments) is zero. Hence the ruler can profit from abusing this trader's rights. In a level of trade lower than the efficient one, however, the value to the ruler of the future trade of the marginal trader may be high enough to enable the ruler to commit to respect the traders' rights. Commerce would expand not to its efficient level but to a lower one. The extent of trade is then a function of the ruler's ability to commit.

If merchants can coordinate a collective retaliation, however, a credible threat by all the merchants to cease trading if any merchant were to be abused enables the ruler to commit at the efficient level of trade. Hence the operation of the reputation mechanism can constrain the use of coercive power. Nonetheless, the threat of collective retaliation is usually not credible: it entails a complete boycott, during which trade would shrink below the level at which, for example, a simple reputation mechanism is effective in supporting some trade. Hence some merchants would renegotiate with the ruler to resume trading.

¹⁴ The following discussion is based on Greif et. al. 1992.

To support the efficient level of trade by having a *multilateral reputation mechanism* constraining the use of coercive power by the ruler, merchants must establish an organization that would not only enable them to coordinate their actions but also could ensure traders' compliance to boycott decisions. In many cases during the pre-modern period, this was achieved by having the merchants take advantage of a political system outside the realm of the ruler to whose territory they traveled to trade. This political system provided the merchants with the coercive power required to ensure compliance with their embargo decisions.

To summarize: this section presented two basic types of institutions that ensure contract enforcement: those using coercive power and those linking current and future economic transactions. Both types of institutions alter the payoffs of the contracting parties in a way that makes compliance optimal. The use of coercive power can come from the state or from "rulers" with sufficient physical force behind them. Institutions based on linking current and future economic transactions do not require the threat of coercive power, relying instead on the threat of the foregone economic gains for the reneging party. Information gathering and dissemination plays a crucial role in both types of institution, and although arbitration may be used in either, it is used for different reasons. In the first, it is used to reduce cost while in the second it is used to coordinate responses.

It is important to note that the historical examples discussed above indicate that at any given moment, the ability to exchange is constrained by existing institutions. Furthermore, history suggests that these institutions do not have an inherent tendency to converge to an

optimal institutional structure.¹⁵ This is true regarding institutions based on coercive power and institutions based on reputation. For example, the inefficient French legal system prevailed for centuries until demolished by the French Revolution. Similarly, the ability of the Maghribi traders to employ agents was constrained by the size of their group, which was determined by social rather than economic factors. In other words, although gains from trade gave rise to institutions that supported some contract enforceability, these institutions were not able to exhaust all gains from trade.

The next sections of this paper demonstrate not only that existing mechanisms used in Russia to ensure contract enforceability bear a remarkable resemblance to the historical examples above and to modern Western institutions, but also that contract enforcement institutions in Russia are a product of Russia's historical development. As such they are neither optimal nor having any inherent tendency to converge to an efficient institutional structure in response to market incentives. Institutional structure seems to be constraining Russia's economic development, and appropriate policy measures should be taken to relax this constraint.

3. History of Contracts and Their Enforcement in Russia

3.1 The USSR before "Perestroika"

The main attribute of the Soviet economy until the late 1980s was its planned nature. The state central planning agency, GOSPLAN, was essentially in charge of all economic activity in the country. It had to construct the production-consumption tables for most major

¹⁵ For additional elaboration on this point, see Greif (1992).

industries, allocate resources, and set production quotas. The five-year plan was prepared by GOSPLAN and approved by the Central Committee of the Communist Party. Actual planning and resource allocation were performed annually, whereas monitoring took place yearly, quarterly, and monthly. GOSPLAN allocated resources directly to particularly important enterprises and municipalities, passing the guidelines concerning the rest to GOSSNAB, the agency responsible for the actual allocation of clients to suppliers. Regional and republican-level branches of GOSSNAB, as well as various ministries, finalized the allocation of clients to suppliers within their areas of responsibility. The allocations would specify quantities, prices (which were set by yet another agency, GOSCOMZEN - "The Visible Hand"), and delivery dates. When this process was completed each enterprise had a list of entities to whom it had to supply its production and a list of its own suppliers.

The plan, as a mechanism for resource allocation, was supposed to render problems associated with contract enforcement obsolete. All contractual obligations were dictated by the state, and their enforcement was supported by the state's authority. In reality, however, because of ideology, informational asymmetry, and managerial incentives this was not the case. Contracts dictated by GOSPLAN were only partially followed or enforced, and other contracts were initiated by the parties and enforced through alternative mechanisms.

Describing the contract enforcing institutions in Russia requires elaboration on these issues.

The five-year plan specified by GOSPLAN was ideologically motivated to demonstrate the growth of the Soviet economy as a proof of the socialist system's superiority. Officially, production was supposed to increase steadily from one five-year plan

to the next.¹⁶ This meant that more often than not the total output plan exceeded the actual production capability of the economy. The magnitude of the discrepancies is illustrated in Table 1, which provides statistics on the ratio of actual production to planned production for the last 20 years of the former USSR.¹⁷

TABLE 1
*Percentage of planned quota fulfilled during the last year
of a Five-Year Plan (by industry)*

<u>Industry/Year</u>	<u>1970</u>	<u>1975</u>	<u>1980</u>	<u>1985</u>	<u>1990</u>
					94
Electricity	89	101	97	100	
Oil	102	101	97	96	91
Natural Gas	88	96	109	107	98
Coal	94	102	91	94	90
Rolled Steel	97	98	90	92	97
Fertilizers	89	100	71	92	77
Plastics	80	82	67	84	81
Fibers	80	91	81	87	80
Presses	83	84	99	N/A	N/A
Trucks	87	89	98	N/A	N/A
Cellulose	61	81	77	90	78
Cardboard	60	74	89	90	81
Paper	84	94	88	94	88

Sources: Planned quotas are from the statistics of the 23rd to 27th Party Conferences (1966, 1971, 1976, 1981, 1986). Actual production is from Narodnoye Hozyaystvo SSSR, years 1975, 1985, and 1990.

¹⁶ Bergson (1989) indicates that from 1966 to 1985 the average quota increased 6% relative to the earlier year.

¹⁷ The numbers in the table actually underestimate the problem for many enterprises, because the military-industrial complex would get its share of the allocation, forcing the others to divide the remains.

The legal mechanism established to enforce contracts and resolve disputes among enterprises was theoretically well suited to the planned system. The State Arbitration Committee under the auspices of the Counsel of Ministers, could order a particular distribution within the state allocation system. It was a government agency (not an independent judicial system) that resolved disputes between state enterprises and enforced contracts. Individuals and semi-private enterprises were not allowed to submit claims. In case of a dispute, the original contract itself was irrelevant, and final decisions were dictated by the plan and current needs. There was little incentive to use the system to enforce contracts and resolve disputes for two reasons: first, it was enough for the manager of an undersupplied enterprise to obtain written confirmation from his superiors that failure to produce the quota was not his fault to avoid responsibility for a production delay. Second, even if the undersupplied enterprise really needed more supplies, its managers were reluctant to bring a formal claim because the plan dictated future interactions between them and the supplier in which the supplier could retaliate. Hence the system was rarely used.

The Civil Code of the USSR, enforced by the state court system governed contracts involving small transactions between individuals, but the contracts were inferior to many other rules and regulations. In particular, contracts consistent with the law but inconsistent with the "rules of socialist coexistence" could be nullified.¹⁸ These courts were used, but their impact on the economy was minuscule.

If an enterprise fulfilled 100% of its planned production, its managers and workers were eligible for a bonus which could be as high as half of their annual salary. Other

¹⁸ The same situation prevailed in most other Eastern European countries as documented by Gray et al. (1992).

benefits, such as housing construction and better consumer goods, were also dependent on 100% plan fulfillment. The marginal incentive in excess of that was negligible. Clearly the managers had strong incentives either to bring their production to the level of the plan or to bargain with the authorities to bring the plan down to the level of current production. The quota was assigned by GOSPLAN, which had to rely on the data supplied by the enterprise itself to evaluate its needs and capacities. Within certain limits, the managers were able to manipulate the data: in particular they could overstate the resources required and to understate the production capacity to increase their chance to get the bonus. Hoarding was common, because nobody could be sure that the next year's allocation and actual delivery would be sufficient for the next year's quota. This was done despite strict reporting guidelines from GOSPLAN. The officials in Moscow had no way of closely watching over 45,000 large and medium-sized enterprises in the USSR. GOSPLAN officials tried to guesstimate this bias by allocating fewer resources and increasing the quota. This adjustment increased the incentives to misrepresent data. As a result, the collected data could not be trusted, and individual enterprises frequently ended up with either more or less resources than were required to fulfill their quotas.

An enterprise could produce, for example, 100 units of its product, yet there might be 120 outstanding claims against these units issued by the state, and all the clients had a right to the allocated amount. Clearly, this right was a necessary, but not a sufficient condition for actually obtaining some or all of it. The directions to the supplier did not specify what to do in case of deficits and hence the supplier had some degree of freedom in choosing whom to supply. Enterprises within the military-industrial complex had enough clout to obtain full

allocations, which, could have accounted for 60 percent of the enterprise's capacity. In our example this means that all the other claimants had to receive 80 units out of the remaining 40--of course, an impossibility. Everybody understood this situation and that if he waited passively for his supplies, they would not be likely to arrive. There was a powerful incentive to spend resources to obtain the largest possible allocation.

The combination of ideology, asymmetric information, and managerial incentives created potentially large discrepancies between planned and actual resource allocation at the enterprise level. To support the actual resource allocation, there was a need for contract enforcement mechanisms other than those provided by the state. The implicit contracts used to support actual allocation were a priority of the enterprise managers and the main task of the *snabjenets*. The latter were employed by almost every enterprise of a reasonable size, and each of them was a salesman in reverse: his goal was to make sure that his enterprise would get most of its allocation. *Snabjenets* did not have an official title, since the position was not supposed to exist. They were hired under the pretense they were highly skilled (and hence highly paid) production workers. *Snabjenets* were the lowest level in an under-economy of resource allocation. The non-price competition for the fixed supply of scarce resources included enterprises' general managers, deputy ministers, and even ministers on the republican level. They frequently paid visits to the suppliers of the most crucial commodities or to their bosses in Moscow ministries and in the Central Committee of the Party.

The actual allocation of scarce resources in many cases was influenced by side payments, either monetary or in kind. In either case the transaction was outside the plan and thus entirely illegal. This created a mutual holdup between the officials (*snabjenets*) of

different enterprises, because both parties potentially could be severely punished. The threat of calling in the state was the major mechanism of contract enforcement. Trust was obviously important, thus long-term relations were cultivated and maintained.

Similar types of informal institutions for contract enforcement evolved in the "parallel (or shadow) economy," another by-product of the planned economy. Imperfect information implied that some products were in excess supply, whereas there was a chronic shortage of others. There were always entrepreneurs who realized the opportunities created by the discrepancies and produced goods (and occasionally services) for which demand was not satisfied. They either organized small scale production or entered into an agreement with a state enterprise to soak up its excess capacity and then distributed the products through official stores and the black market. Their activities — obtaining raw materials, renting production capacity, and distributing the products — constituted criminal offenses. Not surprisingly, the contracts governing these activities could not be enforced in a court of law. The underground economy had to rely on self-enforcing contracts based on long-term relationships and mutual trust, backed by the threat from the state.

It is alleged that a widespread practice in the USSR was for hard-core criminals to look for these underground entrepreneurs to collect protection money. As the actions of the latter were illegal, they could not seek state protection from racketeering. It may have been, however, that in exchange for protection money they got some real protection, both from rival criminals and from partners reneging on contracts. In any case, the criminal forces (racketeers) traditionally played a significant role in the underground economy.

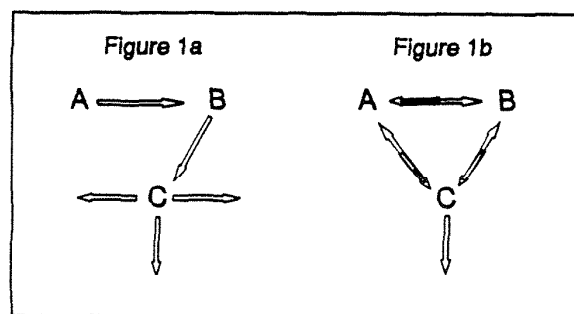
The market voluntary exchange system, based on contracts and mechanisms for their enforcement, did not officially exist in the economy of the Soviet Union. Planning substituted for contracting, and disputes were resolved within the planned framework. But the nature of the official economy gave rise to an underground economy that relied on self-enforcing contracts based on long-term personal relations, informal codes of behavior, and the criminal forces. The judicial system did not develop the expertise to deal with complex contracts and dispute resolution because these were not a legal matter at that time. The laws were not adequate, and the personnel were completely unprepared for what was about to confront them after the break-up of the established order.

3.2 After "Perestroika:"

The main goal of "perestroika" was to promote growth by inducing initiatives at the local level. It was expected that relaxing Moscow officials' regulatory control would facilitate economic growth. Not surprisingly, "perestroika" eroded the central government's power and the rigidity of the centralized contract system. Initially, enterprises were given some freedom to sell part of their above-quota output to clients of their choice. This led to a new type of large-scale transaction among enterprises outside the control of the planning agency.

To understand these transactions, suppose A is a sheet metal plant, B is a refrigeration equipment plant, and C is a meat-processing plant. Before 1986, A would have been assigned to supply sheet metal to B, who in turn would have to supply C with refrigeration equipment. But C's list of clients would not necessarily (or likely) include A or

B. The officially permitted transactions are depicted on Figure 1a with arrows representing the direction of supplies. Since one of the enterprises' responsibilities (especially in the remote areas) was to ensure the supply of foodstuffs to their workers, managers of both A and B needed meat. Yet they could not officially use their contractual relations with C to obtain it. Instead, they had to depend on allocation from the meat-processing plant they were assigned to.



After 1986 other transactions could officially take place using the government set prices, because now all three plants had a certain degree of freedom in allocating their output. A and B could exchange metal for refrigeration equipment; B and C could exchange refrigeration equipment for meat. More complex transactions were very common as well: A would supply B with sheet metal on the condition that C would supply A with meat. These types of transactions are depicted on Figure 1b, with arrows representing the flow of goods. In the latter case it was B's task to ensure contract enforcement, which was supported by their repeated business with each other. Much more complicated transactions, involving several stages of barter exchange, took place as well. In most cases the contracts were not written, signed, or legally binding. Yet because of their repeated business imposed by the official authorities, no legal mechanism was required to enforce these contracts. The specific

individuals who were engaged in this parallel economy frequently helped to arrange the flow of products between the enterprises, using the contacts, expertise, and reputation they had built over the years.

In 1988 it became legal to establish private cooperatives for the purpose of economic activity; later, private small enterprises were permitted as well. A private cooperative had to be sponsored by a state enterprise or organization. The new cooperatives could be classified into three main categories: First, small shops providing services in areas not adequately covered by state enterprises, such as restaurants, tailor and repair shops, and so forth. Second, cooperatives that imported electronics and personal computers for resale to state organizations, enterprises, and individuals, realizing large profit opportunities from price discrepancies. Third, cooperatives engaged in manufacturing and services in affiliation with the state enterprises, and using state-owned resources.

The latter manufactured products for which there was an excess demand and sell them at a price higher or equal to the official one. They paid token fees for the use of the equipment, the raw materials, and the infrastructure of the state enterprise while, in many cases, selling their products to the same enterprises. State enterprises entered into such arrangements since it enabled them to convert the "non-cash" (budgetary) rubles to cash. They received cash from the cooperatives while paying them by state funds that could not officially be used to compensate an enterprise's workers or managers. In many cases, the cooperatives's managers were also the managers of the state enterprise.

The parallel economy veterans were among the first to identify these opportunities and exploit them, because they had the capital, the expertise, and the right "state of mind" for the

newly permitted activity. The new cooperatives had to look for sources of supply and distribution channels, thereby increasing the number of transactions between enterprises with not previous relations that could be facilitated by a legal contract enforcement mechanism. But no such mechanism existed.

The existing legal system provided poor mechanisms for contract enforcement and dispute resolution in this environment. The complexity of transactions translated into complex contracts that could not be dealt with under the current laws and by the existing personnel. There was pressure on the legislative body to modify the Civil Code to accommodate the new reality. But the change was very slow because the issues of contract enforcement were inevitably linked to the question of property rights, which at that time had not been resolved by the parliament. There was a pressing need for alternative mechanisms.

Legal contracts were used only to a very small extent, because more and more regulations were put in place to slow the surge in private activity. Many transactions involved exports of raw materials, the prices of which in the USSR were sometimes less than 10% of the world level. These activities were under particularly tight restrictions, and most of the companies attempted to circumvent them. The contracts were almost never enforceable in the courts, and the plaintiffs would not seek legal redress even if enforcement could be ensured. An alternative contract enforcement system was developed because the deals were too profitable to pass up. Certain practices reduced the possibility of renegeing by using the asymmetry in the ability to use the legal system between the state enterprises and the private firms. One such arrangement was a prepayment scheme: the organization paid up front, expecting the private company or the cooperative to deliver the product. In case of

default the state organization could always file a civil (and sometimes a criminal) suit because it had a much better chance of winning.

The criminal elements followed the underground economy when it started coming to the surface. Racketeering became a widespread problem because there were many opportunities for extortion. Many former athletes and security personnel extorted money from anybody they could identify as a potential victim: street vendors, small shops, restaurateurs, and other small businesses. The costs of doing business were extremely high because of the government and racketeering. Gangs established territories of influence and branched out into additional activities, such as establishing "debt collection" agencies and security firms. The collectors' fee was a percentage of the collected amount, as in the West, but the methods used in Russia were allegedly much more violent. There is no evidence that these gangs actively enforced contracts except for those in which their interests were affected. The police could not cope with the rising tide of illegal activity for several reasons: first, the gangs were multiplying, but the ranks of police did not increase sufficiently to match the new challenge. Second, widespread bribery induced policemen to protect gang members instead of arresting them. Finally, the police had troubles adjusting their methods to the new era of openness. This period marked the beginning of the deterioration of law and order in the USSR.

The break-up of the Soviet Union was followed by a dramatic increase in business uncertainty preceded and followed. It resulted from the disintegration of the planning system, political uncertainty, and rapid inflation. Before the break-up, uncertainty resulted from the decline of central power that increased the authority of local governments. More than ever

before, an enterprise manager had to be attentive to the demands of the regional authority. In a famous summer 1990 incident, the head of Ryasan' Region nearby Moscow refused to supply the capital with meat, because Moscow City Council introduced a rationing policy in the retail stores that excluded non-residents. Despite their obligation under the plan, the enterprises in this region chose to obey the local official. The increase in local power, coupled with various nationalistic considerations, led to a supply system more fragmented and uncertain than ever before. Occasionally, enterprises had to start looking for entirely new sources of supplies and for new clients.

After the break-up of the USSR, political fighting between the former republics led to tariffs, boycotts, export and import restrictions, and outright seizure of assets. The immediate result was that many long term relations between large state enterprises were broken, as their suppliers and clients had suddenly "moved" to another country. The magnitude of these changes is reflected in Table 2, which illustrates the degree to which the enterprises were concentrated in various republics of the Soviet Union before the break-up. Although Russia had a dominant position in almost all industries, in many cases crucial suppliers or customers were located in other republics. New suppliers and clients had to be identified and their credibility established. In addition, the reduction in the importance of central planning increased the number of independent transactions manifold, thus the number of contracts needing enforcement increased dramatically.

TABLE 2

*Market share of enterprises located in
5 largest republics (1990, by industry)*

	REPUBLIC				
<u>Industry</u>	<u>Russia</u>	<u>Ukraine</u>	<u>Belarus</u>	<u>Uzbek</u>	<u>Kazakh</u>
Electricity	62.7	17.3	2.3	3.3	5.1
Oil	90.4	1.0	0.4	0.5	4.5
Natural Gas	78.6	3.5	---	5.0	0.9
Coal	56.2	23.5	---	0.9	18.7
Rolled Steel	57.0	34.5	0.6	0.8	4.4
Electric Motors	22.7	36.9	12.8	1.6	---
Presses	64.7	25.7	2.7	1.4	2.8
Tools (Metal Cutting)	47.2	23.6	9.8	---	1.6
Bricks	53.5	22.9	5.1	4.7	5.0
Cotton Fibers	---	---	---	62.4	3.8
Paper	85.2	6.0	3.2	0.4	0.1

Sources: Narodnoye Hozyaystvo SSSR, 1990.

Gaidar's government, formed in the beginning of 1992, proceeded with rapid price liberalization, the costs and benefits of which were widely disputed. One effect of this policy was inflation reaching between 3 and 9% per week, which introduced new incentives to renege on contracts. The managers of state enterprises, who were used to operating in a stable price environment, did not immediately change their ways of doing business, and many of them suffered large losses in real terms. The potential for reneging prevailed on either side of any transaction: when goods were delivered, payments were postponed. When prepayment was arranged or demanded, sellers charged the list price on the day of delivery,

since contracts usually did not fix the price on the day of prepayment. An additional amount would be requested or the amount of goods delivered would be reduced. The banks, which also benefitted from the float, could take up to two months to transfer the money, causing a client to lose 30 or 40 percent in real terms.

Overall, this period was characterized by a decline in the central (economic and political) power as is reflected in table 1 in the decline in the degree of quota fulfillment. Uncertainty, contractual complexity, and inflation increased while security of property rights deteriorated and many long-term commercial relations were terminated due to political reasons. The legal contract enforcement system showed its inadequacy while incentives for reneging on contracts increased as uncertainty and inflation eroded the ability of reputation based mechanism to support exchange.

4. The Current Status of Contract Enforcement in Russia

The historical structure of contract enforcement institutions in the USSR and the political and economic changes outlined above determine the current nature and efficiency of contract enforcement institutions in Russia. There is an immense demand for inexpensive, quick, and unbiased contract enforcement and dispute resolution mechanisms. Although institutional responses can be observed in Russia, they are wholly inadequate so far.

4.1 The Nature of the Legal Contract Enforcement System in Russia

As we indicated earlier, contract law in the former Soviet Union was mostly concerned with small transactions between private citizens and was not suitable for handling

the large volume of complicated transactions in the very uncertain environment of early 1992. It was based on the 1964 Civil Code, the 1977 Soviet Constitution, and several modifying and generalizing amendments. The reformers of the Russian economy recognized the limitations of this body of law. Two new Russian laws addressed contract enforcement: a December 1990 law on enterprises and entrepreneurial activity, and a July 1991 law on arbitration courts. These were steps in the right direction, but they were far from sufficient.¹⁹ There is a clear need for a comprehensive set of Russian laws governing contracts and their legal enforcement.

This need was supposed to be addressed in the Arbitration Procedural Code (APC) that was approved by the Russian parliament in March and became law in April 1992. It established an entire structure of arbitration courts, which consisted of the High Arbitration Court of the Russian Federation, High Arbitration Courts of the republics in the Russian Federation, and regional and even municipal arbitration courts in large cities. It also provided guidelines for dispute resolution via binding arbitration and the enforcement of these resolutions by the arbitration courts. The following cases were put exclusively under the jurisdiction of the arbitration courts: recognition of property rights and their enforcement; contract enforcement and imposition of damages; and cases involving economic interactions between the state or a state organization and a commercial entity, including all the disputes resulting from privatization, land allocation, registration of enterprises, and other activities involving central and local governments.

The passage of APC was a breakthrough in three major aspects:

¹⁹ At the time of their passage, Russia was not yet an independent state.

1. The law was specifically designed to govern the procedure for the resolution of disputes arising from economic activity. APC presented the arbitration courts with clear procedural guidelines and forced them to use appropriate laws to support their decisions.
2. The arbitration system was transformed from being a government agency, where the decisions were dictated by a bureaucrat, to a judicial entity, mostly independent of the state and basing its judgments on the law.
3. The private citizens engaged in economic activity were given rights to petition the court equal to the largest state and private organizations. They could hire representatives and rely on expert witnesses to advance their cases. This was a major change from a short time ago, when the Arbitration Committee would accept claims only from the state enterprises.

Although APC represents a tremendous advance in the Russian legislative effort, the implementation of this law suffered serious problems. First, there is a lack of qualified legal professionals with expertise in economic affairs in a market economy and a highly uncertain environment. This situation is especially grave in the remote areas, where insufficient resource allocation to the judicial system makes the operation of courts and the enforcement of their decisions all but impossible. Second, despite the procedural clarity, the legal basis for court actions is the modified 1964 Civil Code and peripheral laws, which are still inadequate. For the APC to be effective, the procedures have to be complemented by a set of comprehensive and internally consistent statutes governing property rights, contracts, and other aspects of economic activity. In Russia, the passage of such laws is blocked by the

conservative Parliament, which opposes many of the needed changes for political reasons.²⁰

Third, the local authorities, which are in many cases completely antagonistic to entrepreneurial activity, openly defy certain laws such as privatization and land allocation, and renege on the contracts that these courts are supposed to enforce. Since the courts depend on the local governments, legal contract enforcement in those areas does not exist. Finally, legal market participants have not yet developed a set of norms required for stable economic relations that could be used instead of or alongside the formal laws.

These difficulties are finally getting due recognition, and changes leading to remedies are under way. The Russian Legal Academy and the Bar Association run courses for judges and prosecutors to familiarize them with the statutes and guide them in their implementation. Although the political struggle between the President and the Parliament is slowing down progress in areas where the Parliament has support, there are indications that many republics and regions are lining up behind the President. A new lobby, the Association of Private and Privatized Enterprises, headed by the former Prime Minister Yegor Gaidar, is demanding a comprehensive set of laws on property rights and contracts. The Association holds the lack of such laws to be one of the main concerns of its constituents. Finally, norms of accepted behavior are gradually developing in the Russian business community especially among the larger participants.

The design of the State Arbitration Court system has several practical drawbacks that reduce its usefulness to private companies and individuals. One is that the procedure is fairly costly: in a case involving a monetary claim, the parties are expected to pay 10% of the

²⁰ This constraint was recently removed.

claim as a court fee, splitting it in proportion to the allocation of the claim between the plaintiff and the defendant. Another drawback is that although the court is supposed to pass judgment within a month, it often takes up to six months to come up with a verdict. This is potentially ruinous for the plaintiff in inflationary times. Finally, the court hearings are open to the public unless state secrets are involved. Proprietary information may therefore be released to competitors or to the authorities. Given that the frequently inconsistent rules, and regulations on the federal and the local levels make full compliance with the law all but impossible, the majority of contracts may not be entirely "kosher." As a result companies are reluctant to use the Arbitration Courts because of high costs, long waits, and publicity, resorting to them only if other (more convenient) methods of dispute resolution and contract enforcement are not available. This creates a demand for alternative systems of contract enforcement.

4.2 The Nature of Informal Contract Enforcement in Russia

As outlined in the first section, there are three major avenues through which contract enforcement can be achieved without directly relying on the legal system: self-enforcing contracts in which contract enforcement is achieved by linking economic transactions, binding arbitration in which contract enforcement is indirectly supported by the legal system, and enforcement based on the coercive power of parties other than the state. All these strategies, of which there are numerous historical examples, can be found in Russia today. Their exact form and nature reflects, to a large extent, the nature of informal contract enforcement institutions that evolved in the USSR. Yet the political and economic changes in

Russia undermined the operation of some of these institutions and gave rise to some new institutional forms as well.

1. *Self-enforcing contracts:* Large industrial enterprises in Russia remain monopolies in their respective industries. Despite the loss of contacts with some of their older suppliers and customers, the sheer size and influence of these enterprises allow them to rely on the self-interest of their new suppliers and customers to abide by their contracts and fulfill their obligations. Withholding future business is a very significant threat when it comes from your only customer or supplier. Several private conglomerates possess similar powers. These were established two or three years ago, mainly by people who had informal or formal business relations in previous periods and hence have a long common history and mutual trust. Formal conglomerates, such as Menatep Group, control banks, trading houses, retailing operations, and manufacturing. A company reneging on a contract with such an organization should probably expect legal action but knows with certainty that it will never do business with any of the conglomerate's companies. At the same time, both large state enterprises and conglomerates value their reputation that draws business to them. Thus in most cases contracts are honored, making legal actions very rare.

Reputation-based institutions also provide contract enforceability among smaller business enterprises. This is achieved by forming an interesting organizational structure in which business partners are not connected by any formal organizational ties. We will call these structures "business groups" for a lack of a better name. They are combinations of individuals who are trading in various commodities both within the former USSR and in the

international market. Each trade venture is done separately and requires a separate set of people to put it together; each person is responsible for solving a particular problem such as obtaining credits and export licenses, arranging transportation, or ensuring security. They create a "virtual corporation" for each deal. The contracts are informal; legal documents are prepared, frequently after the transaction has been accomplished, for the sole purpose of satisfying the numerous regulatory requirements. The group may consist of more people than are required for any given deal, and every individual is involved in several deals. If one of the group members reneges on a contract or if there is a dispute, legal action is never considered. Instead the other members (the "elders") pass judgment, which is final. Non-compliance results in the termination of "membership," meaning that no new deals will be offered to the transgressor. Since belonging to one of the business group is very lucrative, contract enforcement is rarely a problem.

Notice the similarity of this institution with the Maghribi traders' coalition described in Section 2. It is hardly surprising, as the similarities in environments led to similarities in the solutions to common problems. The "business groups" described above should not be confused with the Mafia-type organizations discussed below that are involved in various illegal activities alongside their legitimate business. The methods used, the identities of the leaders, and the types of businesses related make the two completely different. Yet reliance on a self-enforcement mechanism is common to both. In the latter case, however, along with the withdrawal of future business, the physical penalty for reneging on a contract can be severe. Disputes are allegedly resolved by people with authority in the criminal world, and the verdict cannot be appealed. Clearly matters are never brought before a court of law.

When a deal involves separate entities with no previous contacts who are not likely to engage in future transactions, multilateral reputation mechanisms can become important. Similar to the situation in the Champagne Fairs, semi-public organization seems to be crucial in providing information. The Russian Chamber of Commerce and Industry compiles a list of large companies (private and state-owned) that provides financial data and records legal actions brought against a company or alleged contract violations. This is similar to the activities of the Better Business Bureaus and Chambers of Commerce in the US and the services of Dunn and Bradstreet Co. worldwide.

Despite the effectiveness of these mechanisms, they constitute "barriers to entry." There is no information on newly established firms or small enterprises. In such cases self-enforcement of contracts based on expected future gains (or past behavior) is not feasible. Although small individually, the enterprises in this category compose the majority of all new business ventures in Russia today. Hence lack of contract enforceability, which restricts the development of this sector has a profound impact on the economy.

2. *Binding arbitration:* Even when large enterprises rely on self-enforcing contracts, disputes are inevitable, especially when the norms of business conduct are not yet firmly established. When two companies have contractual disputes, each can resort to legal action through the arbitration courts but for practical reasons they often prefer to resolve their disputes more cheaply, quickly, and quietly. Binding arbitration has been for a long time a solution for similar problems in the West.²¹

²¹ A recent study by California Bar Association has shown that the arbitration tends to favor compromise, however, and thus its verdicts are more likely than the court system's to force the defendant to pay.

The Arbitration Procedural Act (APC) specifically addresses binding arbitration.

Various organizations are allowed to set up permanent arbitration committees for dispute resolution (called "Tertiary Courts" in Russian). The decision to apply for arbitration has to be mutual, but the decision is binding and cannot be appealed to the Arbitration Court. If the defendant refuses to comply with the decision, the plaintiff can petition the Arbitration Court to issue a ruling forcing the plaintiff to comply. APC specifies that the ruling should be always upheld except when the arbitration committee itself violated the APC statutes. Arbitration committees were established by the commodities exchanges to resolve dispute between the brokers, buyers, and sellers using the exchange (similar to the arbitration common in the US exchanges) and by banking associations to speed up disputes between member banks. The Bar Association has a permanent arbitration committee that can be used by everybody. The two main aspects on which these committees concentrate are the speed of conflict resolution (the Intrabank Credit House arbitration committee resolves all disputes within one business day) and the low cost of arbitration, usually between 1% and 3% of the disputed amount.

The need for dispute resolution and contract enforcement is so great that in June 1993 more than a hundred companies (Russian and foreign), including more than thirty banks and insurance companies paid a membership fee to establish the Moscow Commercial Court, which will be an unaffiliated permanent arbitration committee. Its decisions will be enforced by the Moscow Arbitration Court. By luring highly skilled professional jurists to high-paying positions on this "private court," the organizers commit to resolve disputes within less than a month, charging less than 1% of the disputed amount, which is only ten percent of the

arbitration court fee. Companies based in St. Petersburg are planning to follow the example of their Moscow colleagues.

The permanent arbitration committees are usually set by large organizations, but a provision in APC allows for the establishment of special *ad hoc* arbitration committees to resolve disputes. Participation is voluntary; the number of committee members is usually three, one appointed from each side and the third appointed by the other two. The decision is binding, and the rules of enforcement are the same as for the permanent committee. Use of this provision is reported to be fairly high. The basic advantages of the process were outlined above: speed, cost effectiveness, and no sensitive information leakage.

The particular importance of the APC is that there is no attempt by the state to monopolize the dispute resolution mechanism. The difference between the English and French systems, described in Section 2, comes to mind: lack of competition in the dispute resolution services tends to increase the transaction costs and thus slows down economic development. Fortunately, the Russian system encourages competition in this area.

3. *Private enforcement by force:* The surge of racketeering and other criminal activity surrounding business transactions started in the late 1980s and has increased ever since. The criminal elements understood very quickly that it is much more profitable to engage in business activity instead of extorting money from people who engage in it. In the early 1990s, former criminals are already moving into legitimate businesses such as trade, entertainment, construction, and even banking. The use of coercive power was not

abandoned, but appeared in the form of security personnel used to defend the firm from extortion attempts from other criminal groups and to enforce contracts with other parties.²²

In a business world where one competitor has the ability and will to use coercive power, other competitors have to acquire matching coercive ability or get out of business. Without reliance on physical force an enterprise cannot withstand the pressure of extortion and cannot enforce contracts with other entities who can use force. Not surprisingly most banks and many large private companies maintain large security departments. Bank security people are used to fend off any attempts to extort cheap credits or to collect delinquent debts. An acquaintance in Russia told us a story about an executive in a commercial bank whose husband was approached by a group of people with a request to help them obtain a loan. When he refused, they threatened him. The woman went to the extortionists' hotel room and told them that if they ever spoke to her husband again, she would report them to her bank's security department. They were never heard from again. When we asked whether the security department would have done anything, our friend assured us that the bank had no choice but to use physical force to prevent such attempts; otherwise they would lose the bank. This story illustrates banks' ability and willingness to use coercive power and the costs of doing business in this environment. Western countries long ago adopted a more efficient system, where the state acts as the primary defender and deterrent against extortion and enforces contracts. This eliminates the need for costly duplication of efforts by many market participants.

²² This is not to say that criminal activity is completely abandoned. Other groups now control drugs, prostitution, theft, extortion, and murder. But even they are becoming more businesslike than before; it is reported that now the most popular form of extortion is to force property owners to sell very cheaply.

Collection agencies also exist, but now the more lucrative business is to provide security services. Rather than maintaining a sufficient security force, a company hires a security firm to perform the same functions for a monthly fee. In some cases firms with large coercive force behind them are taken as partners. On one hand, this is an efficient use of resources because of the economies of scale in protection services. On the other, there is always a danger of a firm being taken over by the security firm that is supposed to protect it.

Some businesses use these firms despite the danger of being drawn into the criminal world, but others choose to forgo potentially profitable transactions because enforcement costs are too high. Certain areas of business in Russia today are based on feudal relations. The "rulers" collect taxes from their subjects, making it optimal for the former to protect the latter from other rulers so that the tax amount will be maximized. One form of protection is contract enforcement. If somebody owes money to the ruler's "subject," the ruler has an incentive to collect it because part of it will become his. Although there is no hard evidence on contract enforcement by the security firms since they tend to keep their dealings secret, contract enforcement by them would be quite natural.

As stated earlier, some companies that would prefer to use the legal mechanism are forced to use private enforcers instead. The abundance of laws prohibiting certain transactions, imposing high taxes, and limiting the market functioning pushes many businesses into the semi-legal world. This is especially true when many authorities issue conflicting decrees, as is happening in Russia. Unable to use the legal system, these businesses are pushed by the government into the private enforcement mechanisms.

The private enforcement system is used as a deterrent by large companies with their own security departments, which forces their smaller counterparts to use other forms of contract enforcement to level the playing field. This makes the costs of doing business for a small enterprise in Russia very high. Small businesses are the driving force in the changes taking place in the Russian economy, and the consequences of this are quite dramatic. The system is wasteful because the economies of scale in protection and contract enforcement are not exploited. Disputes are frequently resolved by people with little or no understanding of the issues involved. Moreover, the decisions are made on the basis of the force standing behind one of the parties. This makes the process unpredictable, since the relative strength of the parties can change. New forces will attempt to emerge to take their place; violent conflicts will be a substitute for a law school diploma. Decision making in such unpredictable conditions requires a high risk premium, so many profitable projects are not undertaken. For the projects that are undertaken the required rate of return is very high (as observed in Russia currently), and prices will reflect that. Another danger of using the private enforcement mechanism is that one never knows how to break the ties with the enforcers, because any criminally related activities lead to other criminal activities. Private contract enforcement may lead to racketeering the same way the racketeering leads to private enforcement.

5. Conclusion

We conducted an informal experiment by comparing the responses of American MBA students and Russian students in economics to the following question: "What is the role of

the state in the marketplace?"²³ According to the Russian students, contract enforcement was the most important task of the state. In sharp contrast, the American students realized the need to define and protect property rights and to enforce contracts only after extensive prodding by the instructor. These responses illustrate the differences between the two economies in their current development. The American students did not mention contract enforcement and property rights protection because these are taken for granted in a system committed to these tasks. Russian students see close up the problems stemming from the state's inability to enforce legal contracts.

As reflected in the answer of the Russian students, the current contract enforcement institutions in Russia are insufficient. The legal system is still burdened by its own past: it lacks appropriate rules, tradition, and trained experts. At the same time, the political and economic uncertainties undermine the ability of reputation mechanisms to provide contract enforceability. Some features of the previous period — the existence of large conglomerates and networks of informal relations — support some reputation-based institutions. Adapted to the new situation, these institutions ensure contract enforcement to some degree but at the cost of forestalling entry of new firms and hence the emergence of competitive economy. *New reputation-based institutions seem to be emerging as well. Another institutional form that involved the use of coercive force by organizations other than the state is also on the rise.*

The overall institutional structure is far from being efficient or even converging toward being efficient. In particular, small and new businesses are unable to commit

²³ Details regarding this survey are available from the Eugene Kandel.

themselves to honor their contracts. The resulting barriers to entry forestall the growth of a market economy in the short run and are likely to lead to uneven income distribution and under-utilization of entrepreneurship in the long-run. Contract enforcement institutions based on coercive power promote growth by enabling contract enforcement; they forestall growth by increasing the transaction cost of doing business relative to the situation in which the government has a monopoly over coercive power and is restricted to use it for the provision of impartial justice through a "competitive" court system.

In Russia today, the absence of an appropriate institutional infrastructure for contract enforcement is producing severe economic problems. One basic cause is a lack of attention on the part of Russian economists and politicians to contract enforcement. This lack of attention is reflected, for example, in a book titled "The Difficult Transition to Market" (July 1990) edited by Academician Leonid Abalkin, who was President Gorbachev's economic advisor. It is a collection of thoughts and prescriptions by all the leading Russian (and several Western) economists on the policy required to accomplish the transition to a market economy. Although it raises many important points, it does not even mention the lack of legal or extra-legal contract enforcement as an impediment to the development of a market economy.

Addressing aspects of contract enforcement is required to facilitate economic growth in Russia. In particular, legislation for the improvement of the operation of the legal system is needed as soon as possible. In addition, market participants and legal personnel should be educated regarding the nature of property rights and contracts in a free exchange economy as well as the basic principles the legal system is to use in resolving disputes. Furthermore,

policy should take into account the inter-relations between institutions based on the legal system and extra-legal institutions. Market economies are fundamentally based on the ability to exchange. This ability (and hence economic development) is limited by the extent of contract enforcement.

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